

UNITED STATES BANKRUPTCY COURT FOR THE NORTHERN DISTRICT OF IOWA

IN RE:)

) Chapter 7

JOSEPH J. SULLIVAN,)

CAE S. SULLIVAN,) Bankruptcy No. 02-03073

)

Debtors.)

ORDER RE: MOTION FOR COMPROMISE OR SETTLEMENT OF CONTROVERSY

This matter was heard on May 11, 2006 on a Motion for Compromise or Settlement of Controversy. Wes Huisinga appeared as Chapter 7 Trustee and Mark Lawson appeared for Debtors Joseph J. and Cae S. Sullivan. After the presentation of evidence and argument, the Court took the matter under advisement. This is a core proceeding pursuant to 28 U.S.C. § 157(b) (2) (A).

STATEMENT OF THE CASE

Debtors filed a lawsuit against Dubuque Racing Association involving prepetition business activities of the Association. Trustee claims the lawsuit as property of the bankruptcy estate and seeks Court approval of a proposed settlement with Dubuque Racing Association covering the claims raised by Debtors in the lawsuit. Debtors claim that the lawsuit is not property of the estate.

FINDINGS OF FACT

Debtors filed a Chapter 7 petition on August 31, 2002. Discharge entered, and the Court issued its final decree closing the case on December 4, 2002. Trustee filed a motion to re-open the case on February 27, 2006 asserting that Debtors had a previously undisclosed asset in the form of a cause of action against the Dubuque Racing Association. This Court granted the motion and reappointed the Trustee.

Debtors owned greyhound dogs which were raced at the Dubuque Racing Association's racetrack. The dog owners "received winnings in the form of purses and purse supplements." Sullivan v. Dubuque Racing Ass'n, No. LACV 053644, slip op. at 1 (Iowa Dist. Ct. Mar. 8, 2006) (order denying Defendant's motion for summary judgment and allowing Debtors' suit to continue) (included as Exhibit 5 of Brief of Trustee). The size of the purse supplement was directly related to the tax rate - the greater the taxes paid to the State, the smaller the purse supplement. Id.

The tax structure in place during the period of 1997 through 2002 called for gross receipts from gambling operations at racetracks to be taxed at rates higher than those from similar operations at riverboats. Racing Ass'n of Cent. Iowa v. Fitzgerald, 675 N.W.2d 1, 4 (Iowa 2004). Since the winners' purses were determined in part by subtracting out taxes paid to the State of Iowa, this disparate tax structure had an impact upon the size of the purse supplements available to the winners of the dog races, including Debtors. Thus, Debtors suffered an economic loss each time they were paid from a purse supplement that was less than it would have been if the racetrack tax rate were equal to the lower rate applied to riverboats.

A group of interested parties, including Dubuque Racing Association (DRA), successfully sued the State of Iowa over its method of taxing pari-mutuel dog

racetracking. The litigation lasted several years. Debtors were aware of the litigation at the time it was ongoing, prior to filing their bankruptcy case in August 2002. Brief of Trustee, Document 27, Exhibit 1 at 30-31. Ultimately, the Iowa Supreme Court found the disparate tax rates violated the State equal protection clause and found the portion of the tax rate applied to racetracks which exceeded the tax rate applied to riverboats to be unconstitutional. Fitzgerald, 675 N.W.2d at 16.

On remand to the Iowa District Court, Dubuque Racing Association and the other plaintiffs (a group that did not include Debtors) obtained a multi-million dollar judgment for overpayment of taxes during the years 1997 through 2002. However, it appeared unlikely that the plaintiffs would ever be able to collect on the judgment. Haynes v. Iowa West Racing Ass'n, No. LACV 087160, slip op. at 6 (Iowa Dist. Ct. Nov. 15, 2005) (included as Exhibit 4 of Brief of Trustee). Enforcement of the judgment would have created a state fiscal crisis. See *id.* The Iowa legislature indicated an unwillingness to allocate funds to satisfy the judgment against the State treasury and also indicated that taxes would be raised to offset any payments made (or forced) in satisfaction of the judgment. *Id.* The parties eventually entered into a settlement with the State of Iowa that called for future reduced taxes in exchange for waiver of the claims and judgment for past overpayment of taxes. The prospective "reduction" in taxes established tax rates equal to the rates levied against riverboats with the exception of limited situations where racetracks were to be taxed at a rate two percentage points higher than riverboats. See Iowa Code § 99F.11 (governing the tax rates imposed upon gambling facilities).

Debtors filed suit against the Dubuque Racing Association in 2004 and made claims under the following theories: status as third party beneficiaries, promissory estoppel, and constructive trust. Sullivan, No. LACV 053644, slip op. at 3. In a hearing before this Court, Debtors argued two strands of claims against DRA: (1) contract claims as a third party beneficiary to the refund of taxes owed to DRA as a result of the State district court judgment and (2) equitable claims created as a result of DRA's decision to sign a settlement agreement with the State that waived rights to collect upon the judgment.

CAUSES OF ACTION AS BANKRUPTCY ESTATE PROPERTY

The property of the bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). "The property of a bankruptcy estate is 'broadly defined,' and encompasses conditional, future, speculative, and equitable interests of the debtor." U.S. ex rel. Gebert v. Transport Administrative Services, 260 F.3d 909, 913 (8th Cir. 2001) (citation omitted). These property rights are broadly construed, to include contract rights which may be contingent upon future events. In re Wick, 249 B.R. 900, 909 (Bankr. D. Minn. 2000). "In fact, every conceivable interest of the debtor, future, nonpossessory, contingent, speculative, and derivative, is within the reach of § 541." In re Yonikus, 996 F.2d 866, 869 (7th Cir. 1993).

ACCRUAL OF CAUSE OF ACTION

According to Debtors, their legal and equitable interests in obtaining a judgment against Dubuque Racing Association did not accrue until the following post-discharge events occurred: 1) the Iowa District Court entered judgment for back taxes and 2) DRA subsequently settled with the State of Iowa.

When a contract has been "substantially completed before bankruptcy," and all that remains is payment of money, "the claim becomes a chose in action which passes to the estate." In re Ryder, 73 B.R. 116, 117 (Bankr. S.D. Fla. 1987). Claims which are "sufficiently rooted" in prepetition activities are property of the bankruptcy estate. In re Plumlee, 236 B.R. 606, 612 (E.D. Va. 1999). Even debtor's contract rights which arise under postpetition contracts may be part of the estate. In re Albion Disposal, 217 B.R. 394, 407-08 (W.D.N.Y. 1997).

Upon filing for bankruptcy, the estate includes unpaid earnings "because the debtor has both a legal and an equitable interest in receiving payment." In re Irish, 311 B.R. 63, 66 (B.A.P. 8th Cir. 2004). The Irish case involved an Iowa teacher who had already earned wages, but had not yet been paid at the time she filed for bankruptcy. Id. at 64. While earned but unpaid wages are part of the estate, the Appellate Panel concluded that earnings from services after commencement of the case are not property of the estate. Id. at 66. Thus, income flowing from prepetition activities of a debtor rightfully belongs to the estate while income from postpetition activities is shielded from the estate (and therefore from creditors) so that debtors are encouraged to begin their "fresh start." See id.

Debtors filed suit against Dubuque Racing Association on the theory that they have accrued winnings which were not paid to them. The foundation of their suit is based entirely on the underpayment of winnings prepetition. Thus, their interest in any underpayment of winnings existed as of the period of 1997- 2002. Debtors were aware of the underpayments as evidenced by their awareness and apparent support of DRA's litigation against the State of Iowa, even though they had to wait several years for the Courts to make a judicial determination that they had indeed been underpaid. Further, the Iowa Supreme Court found the tax scheme that caused their underpayment of winnings to be unconstitutional before Debtors filed for bankruptcy. Fitzgerald, 648 N.W.2d at 562. Thus, Debtors' right to collect on the basis of underpaid winnings had matured prepetition, even if the exact amount was still awaiting a final determination in the Iowa courts.

Debtors' theory regarding when their right to sue came into existence is problematic. Debtors claim they could not have made their equitable claims until April 2004 because, until that time, DRA had not yet signed away Debtors' right to a share of the refunded taxes by entering into a settlement with the State of Iowa. That is, until that time, DRA had not breached or otherwise failed to make good on its obligation to re-pay Debtors for their underpayment of winnings.

Debtors' arguments require an examination of two theories of when a cause of action exists. These theories are the "conduct" theory and the "accrual" theory. The "conduct" theory determines the date of a claim by the date of the conduct which gives rise to the claim. The "accrual" theory determines the date of a claim under the State law applicable where liability for the claims arose. In re Parker, 313 F.3d 1267, 1268 (10th Cir. 2002).

While there is a split of authority among the circuits as to which theory should apply, the Third Circuit is the only circuit which has formally adopted the "accrual" theory. In Re M. Frenville Co., Inc., 744 F.2d 332 (3d Cir. 1984) cert. denied, 469 U.S. 1160 (1985).

The Eighth Circuit has not formally adopted or rejected either theory. In the only Appellate decision citing Frenville, the Eighth Circuit Court of Appeals had the opportunity to discuss Frenville, as the plaintiff cited Frenville in support of its position. The Court concluded that Frenville did not support plaintiff's position. However, the Court did not discuss the merits or precedential value of Frenville, nor did it express any preference between the "conduct" or "accrual" theories. McSherry v. Trans World Airlines, 81 F.3d 739, 740-41 (8th Cir. 1996).

In considering whether a claim arose prepetition for automatic stay purposes, the Federal District Court in Minnesota also observed that the Eighth Circuit Court of Appeals had not adopted either the "conduct" nor the "accrual" theory. The Court, however, concluded that, if presented with the issue, the Circuit would not adopt the Frenville analysis. In re Transportation Systems Intern., 110 B.R. 888, 894 (Bankr. D. Minn. 1990) ("Although the Eighth Circuit has not directly addressed the question of when a claim arises for bankruptcy purposes, it appears very unlikely that the court would follow Frenville"). The bankruptcy courts of the Eighth Circuit have considered this issue in three cases. Two cases adopted the "conduct" theory. In re Wisconsin Barge Lines, 91 B.R. 65, 68 (Bankr. E.D. Mo. 1988) and In re Food Barn Stores, 175 B.R. 723, 731 (Bankr. W.D. Mo. 1994). The sole case which appears to reject the "conduct" theory in favor of the "accrual" theory is In re Hoffinger Industries, 307 B.R. 112, 120 (Bankr. E.D. Ark. 2004) where the Court states: "Thus, the Court rejects application of a Conduct Test that would give rise to 'claims' simply because the design and manufacture of products occurred prepetition".

It is the conclusion of this Court that the great weight of authority supports the "conduct" theory. For purposes of determining includability in Debtors' bankruptcy estate, it is the factual determination of this Court that Debtors completed all activities prepetition. The completion of these activities provided Debtors with a legal and equitable interest in subsequent determinations that they were underpaid in their winnings. For purposes of the bankruptcy estate, Debtors' legal and equitable interests existed at the time of the filing of their bankruptcy petition. As Debtors' causes of action existed prepetition against Dubuque Racing Association, these causes of action are rightfully property of Debtors' estate.

REASONABLENESS OF THE SETTLEMENT

The next issue concerns the reasonableness of the settlement. Upon motion of the trustee and with notice to interested parties, "the Court may approve a compromise or settlement." Fed. R. Bankr. P. 9019(a). In determining the reasonableness of the settlement, the Court must examine:

- (a) The probability of success in the litigation;
- (b) the difficulties, if any, to be encountered in the matter of collection;
- (c) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it;
- (d) the paramount interest of the creditors and a proper deference to their reasonable views in the premises.

In re Patriot Co., 303 B.R. 811, 815 (B.A.P. 8th Cir. 2004)

(citing In re Flight Transp. Corp. Securities Litigation, 730 F.2d 1128, 1135 (8th Cir. 1984)). These four factors originated in Drexel v. Loomis, 35 F.2d 800, 806 (8th Cir. 1929).

So long as the settlement offer does not fall below the lowest point of "reasonableness," the Court may approve the settlement offer proposed by the Trustee. In re New Concept Housing, Inc., 951 F.2d 932, 938 (8th Cir. 1991). The determination of "fair, reasonable and adequate" under Federal Rule of Civil Procedure 23(e) is left to the "sound discretion of the trial judge." Flight Transp. Corp., 730 F.2d at 1135. In making that determination, the Court must apply the four Drexel factors. *Id.*

A. PROBABILITY OF SUCCESS IN THE LITIGATION

The likelihood of success in litigation does not appear very realistic. While Debtors' claims have survived a summary judgment challenge, the factual issue for the jury remains as to whether the settlement made by Dubuque Racing Association was a reasonable and perhaps unavoidable choice or that the parties to the settlement, including DRA, were maximizing their own future interests to the detriment of those who incurred losses in the past. Sullivan, No. LACV 053644, slip op. at 5. "Reasonable minds could differ on the issue...." *Id.*

Further, similarly situated litigants in Council Bluffs were unsuccessful in asserting similar claims against another dog- racing facility. In Haynes, the plaintiffs raised three claims:

(1) they were third party beneficiaries of contracts between the racetrack and the Iowa Greyhound Association; (2) the defendant bargained away its rights to recover past losses in order to gain future favorable tax treatment (and thus the plaintiffs were owed a constructive trust on its profits); and (3) the plaintiffs relied to their detriment on promises contained within the contracts between the defendant and the Iowa Greyhound Association. No. LACV 087160, slip op. at 4. Like Debtors, the Hayneses sought to claim the difference between the actual purses they were awarded and what they would have received if the portion of the Iowa gaming tax that was declared unconstitutional had never been enacted. The Hayneses were unsuccessful in asserting that claim. *Id.* at 8-9. Likewise, the Haynes Court refused to recognize their claim as third party beneficiaries, another theory upon which Debtors in the instant case rely in their suit against Dubuque Racing Association. *Id.* at 8-9.

B. DIFFICULTIES IN COLLECTION

Difficulty in collecting a judgment in this action does not appear to be an issue in this case.

C. COMPLEXITY OF THE LITIGATION INCLUDING EXPENSE, INCONVENIENCE AND DELAY

The case against DRA is not overly complex; however, the expense of pursuing litigation when there are no funds within the bankruptcy estate to pay for such expense is a significant factor in motivating Trustee to pursue a settlement. Further, the creditors have been waiting nearly four years for some distribution from the estate. Continuation of the litigation will result in still further delays.

D. PARAMOUNT INTERESTS OF CREDITORS AND DEFERENCE TO THEIR REASONABLE VIEWS

Generally, the paramount interest of creditors is to maximize the amount they are able to collect on their claims. At the time of Debtors' original final decree, the case was a no-asset one and no creditors were paid. With the re-opening of the case, creditors have an opportunity to have some portion of their claims against Debtors satisfied.

In weighing the above four factors in determining the reasonableness of the settlement, the Court finds that the Trustee's proposed settlement of \$5,000 in exchange for an assignment of claims to be a fair, reasonable and adequate one.

REIMBURSEMENT TO DEBTORS FOR EXPENSES OF FILING AND PROSECUTING LAWSUIT AGAINST DUBUQUE RACING ASSOCIATION

The claim and cause of action against Dubuque Racing Association properly belongs to the bankruptcy estate. As such, Debtors did not have standing to bring suit against DRA in the first place. Carlock v. Pillsbury Co., 719 F.Supp. 791, 856 (D. Minn. 1989). Further, only the Trustee, with Court approval, is empowered to hire attorneys to represent the interests of the estate. 11 U.S.C. § 327(a). Neither the Trustee nor the Court approved of Debtors' decision to represent the interests of estate property. "The fact that the services rendered may have benefitted the estate is not grounds to ignore the requirements of the Bankruptcy Code." In re Welch, 244 B.R. 802, 804 (Bankr. W.D. Ark. 2000) (refusing to compensate Debtors' attorney for pursuing claims owned by the bankruptcy estate without trustee or court authorization). Since Debtors had no standing nor authorization to pursue a claim on behalf of the bankruptcy estate, the Court declines to award reimbursement for expenses incurred by them in this litigation.

CONCLUSION

The Court concludes the proposed settlement agreement between Trustee and Dubuque Racing Association should be approved. Since the claim belongs to the bankruptcy estate, Trustee has acted appropriately in seeking to secure a reasonable settlement for the benefit of the creditors. Since the claim is property of the estate and not one for Debtors to make in the first place, the Court declines to award reimbursement for Debtors' unauthorized expenses.

WHEREFORE, Trustee's Motion for Compromise or Settlement of Controversy is GRANTED.

FURTHER, Debtors' petition for reimbursement of litigation expenses related to the suit against Dubuque Racing Association is DENIED.

DATED AND ENTERED: June 13, 2006

PAUL J. KILBURG
CHIEF BANKRUPTCY JUDGE